

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date:

March 15, 2007

Legend

Taxpayer =

State A =

Date B =

County C =

County D =

E =

F =

g =

h =

i =

j =

k =

l =

m =

n =

x =

Year 1 =

Year 10 =

Year 11 =

Year 14 =

Year 17 =

Year 19 =

Year 29 =

Year 30 =

Dear :

This is in reply to a letter dated November 6, 2006 submitted on behalf of Taxpayer requesting consent to Taxpayer's revocation of its election under § 831(b)(2)(A)(ii) of the Internal Revenue Code, effective for the Year 30 calendar tax year. Additional information was submitted in a letter dated January 16, 2007.

Taxpayer is a State A corporation which was formed on Date B. Taxpayer is engaged in business as an assessable mutual insurance company providing coverage to its x members primarily located in County C and County D within State A. The coverage that Taxpayer provides is principally property coverage, however, more recently to meet competition from unrelated insurance carriers (viz., units of the E group and the F group) it has been adding liability coverage.

Taxpayer elected for Year 11 to be taxed only on its investment income under § 831(b)(2)(A)(ii).

In recent years, Taxpayer has incurred more underwriting losses than it has in the past due to: (1) its provision of broader coverages without Taxpayer being able to receive sufficient premiums to fully recover the cost of its losses and expenses generated by the additional risks assumed, (2) its significantly increased repair costs, (3) its increased operating expenses, and (4) generally, its inability (due to competition) to increase the premium charged to its members. Because of these underwriting losses, Taxpayer's tax liability in recent years has been greater than it would have been had its § 831(b) election not been in effect.

With regard to broadened coverages, beginning in Year 14 coverages have evolved from depreciated value to a replacement value approach.¹ In addition, liability cover was added in Year 17 and theft coverage was added in Year 19. Taxpayer's loss ratio (calculated by the ratio of incurred losses plus loss adjustment expenses over earned premiums) was g percent in Year 10 and had risen to h percent in Year 29. As a result of competition, however, Taxpayer is unable to fully recover in premiums the losses and expenses associated with the additional risks assumed under its current policies.

The second factor that has changed from Year 10 to the present is the increased cost of contractors and material costs. To illustrate, from Year 10 to Year 29, the cost of replacing a square of roofing material increased from \$35 per square to \$110 per square representing a percentage increase of over 314 percent.

The third factor is that Taxpayer's expenses have increased significantly in the past 20 years. Taxpayer's trade basis expense ratio (calculated by the ratio of expenses incurred over net written premiums) was i percent in Year 10 and had risen to j percent in Year 29. Further, Taxpayer's reinsurance premiums as a percentage of direct premiums written have increased from k percent in Year 10 to l percent in Year 29.

The fourth factor is that (as indicated above) Taxpayer (in spite of its broadened coverages designed to attract and retain policyholders) because of competition has actually has slightly reduced its premium rate per thousand dollars of coverage that it charges its members. Thus, Taxpayer for Year 29 charged \$m per thousand which is lower than the \$n per thousand rate it charged in Year 10.

¹ In Year 1 assuming hail damaged a brand new roof that had a replacement cost of \$1,000, the policyholder would receive the full \$1,000 replacement cost. However, if the damage occurred in Year 10 when the roof was 10 years old (and the roof was one half way through its 20 year useful life) and cost \$1,400 to replace, pursuant to the policy then in effect Taxpayer would pay the member/policyholder \$700. (Forty squares at \$35 per square to replace = \$1,400 times a 50% depreciation charge.) Under the "full replacement cost policy" in effect in Year 29 the roofing job would cost Taxpayer \$4,400 and that full value would be paid to the member. (Forty squares @ \$110 per square to replace and as no depreciation factor reduced the payment to the member the member receives the full \$4,400.)

Taxpayer represents that it believed when it first made the election, that the election would be an annual one.

Section 831(a) of the Internal Revenue Code imposes a tax for each taxable year on the taxable income of every insurance company other than a life insurance company.

Section 831(b) provides an alternative tax that applies to an insurance company other than a life insurance company if (i) the company's net written premiums (or, if greater, direct written premiums) do not exceed \$1,200,000, and (ii) the company elects the application of § 831(b) for the taxable year.

Section 831(b)(3) provides that, for purposes of Part II of subchapter L, except as provided in § 844, a net operating loss (as defined in § 172) shall not be carried - (A) to or from any taxable year for which the insurance company is not subject to the tax imposed by § 831(a), or (B) to any taxable year if, between the taxable year from which such loss is being carried and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by § 831(a).

Section 831(b)(2)(A) further provides the following regarding the effect of making the election: The election ... shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements ... are met. Such an election, once made, may only be revoked with the consent of the Secretary.

The two sentences quoted above from § 831(b)(2)(A) were not in § 831(b), as originally added to the Code by § 1024(a)(4) of the Tax Reform Act of 1986, Public L. No. 99-514. These sentences were added to the Code by § 1010(f)(1) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Pub. L. No. 100-647. The change to § 831(b)(2) of the Code was retroactively effective for the tax years beginning after December 31, 1986 (the same effective date as the applicable to the rest of § 831(b)). See § 1019(a) of TAMRA and § 1024(e) of the Tax Reform Act of 1986.

The Senate Finance Committee offered the following explanation for the two sentences added to § 831(b) by § 1010(f)(1) of TAMRA:

The bill clarifies that the election to be taxed only on investment income, once made and so long as the requirements for the election are met, may be revoked only with the consent of the Secretary. This clarification reflects Congress' intent that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer does not have net operating losses), but rather as a simplification for small companies.

S. Rep. No. 445, 100th Cong., 2d Sess. 127 (1988).

As indicated above, the nature of Taxpayer's business has changed significantly in several ways: (1) its provision of new broader coverages without being able to cover the costs of supplying the coverages, (2) its repair costs significantly increased, (3) its operating expenses (including reinsurance) have likewise increased, and (4) due to competition its premiums have remained level (or have been slightly reduced). Taxpayer represents that it will not make an election under § 831(b) to be taxed on its investment income for any of the first five taxable years following the year to which the consent granted in this letter relates.

Accordingly, consent is hereby granted to Taxpayer to revoke its § 831(b) election, effective for its calendar Year 31.

Except as expressly provided herein, no opinion is expressed under the provisions of any other section of the Code or Regulations. This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to any Federal income tax return to which it is relevant.

In accordance with the power of attorney on file in this office, we are sending a copy of this letter to your authorized representative.

Sincerely yours,

/S/

DONALD J. DREES, JR.
Senior Technician Reviewer
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Office of Associate Chief Counsel
(Financial Institutions & Products)